SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1927

No. 156

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PETITIONER

vs.

MILTON DAIRY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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a [Caption omitted.]

1 In United States District Court, District of Minnesota, Third Division

MILTON DAIRY COMPANY, PLAINTIFF

vs.

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, DEFENDANT

Complaint

Filed Jan. 14, 1925

The above named plaintiff for its complaint herein complains of the above defendant and alleges:

I

Plaintiff states that it is a corporation duly organized and existing under the laws of the State of Minnesota, having its principal place of business in the city of St. Paul, State of Minnesota, and that defendant now is and at all times herein mentioned was the duly appointed, qualified, and acting collector of internal revenue for the district of Minnesota.

II

Plaintiff for its first cause of action states that on or about the 3rd day of July, 1922, the Commissioner of Internal Revenue did
2 compute and assess additional income and excees profits taxes against this plaintiff for the fiscal year ending February 28th, 1919, in the sum of $4,141.57, and that of the amount so assessed the sum of $1,274.30 was erroneously and illegally assessed.

III

Plaintiff states that on or about the 25th day of January, 1923, the Commissioner of Internal Revenue and the collector of internal revenue did serve on this plaintiff a written notice and demand notifying this plaintiff that there had been assessed an additional income and profits tax for the fiscal year ending February 28th, 1919, amounting to $4,141.57, which additional tax included said sum of $1,274.30, erroneously and illegally assessed, and demanded of this plaintiff the payment of the same.

IV

That on or about the 31st day of January, 1923, in order to prevent penalties and interest, and pursuant to the aforesaid demand, said

plaintiff paid to said L. M. Willcutts, collector of internal revenue, the sum of $4,141.57, which included the sum of $1,274.30, erroneously and illegelly assessed. Copy of receipt of said collector for said payment is hereto attached marked Exhibit "A" and made a part hereof. Said payment was duly made under protest and duress.

V

That the commissioner in arriving at the amount of the tax for the fiscal year ending February 28th, 1919, omitted from the computation of invested capital the undivided profits of the preceding fiscal year, which profits remained in the business, amounting to $11,489.26, and such omission resulted in an illegal assessment of taxes amounting to $1,274.30.

VI

Plaintiff states that prior to the making of said assessment of additional tax the books and accounts of this plaintiff were examined, by an agent of the Commissioner of Internal Revenue, and that it appears from said examination that prior to the beginning of said fiscal year the capital of said corporation had been impaired by an operating deficit, and it further appeared from said examination that the profits remaining in said business for the preceding fiscal year, and which remained in the business for said fiscal year ending February 28th, 1919, amounted to $11,489.26, and it further appears from the report of said agent that in computing said
3 tax said agent and said Commissioner of Internal Revenue did exclude from the computation of invested capital the said sum of $11,489.26, and said failure to include said sum in the computation of invested capital of this plaintiff was erroneous and illegal, and by reason thereof the additional assessment made against this plaintiff as aforesaid was erroneous and illegel in the amount of $1,274.30.

VII

Plaintiff states that thereafter on or about the 9th day of February, 1923, it duly filed with the collector of internal revenue for presentation to the Commissioner of Internal Revenue an application for refund in manner and form as provided by the law and the regulations then in force, applicable to said case, copy of which is attached hereto marked Exhibit "B" and made a part hereof, and that said Commissioner of Internal Revenue on November 8th, 1923, wholly disallowed and rejected said claim for refund.

VIII

That by reason of the facts hereinbefore stated and alleged there is due and owing to this plaintiff from the defendant herein the sum of $1,274.30, with interest thereon from the 31st day of January, 1923.

IX

Plaintiff for its second cause of action states that on or about the 3rd day of July, 1922, the Commissioner of Internal Revenue did compute and assess additional income and excess-profits taxes against this plaintiff for the fiscal year ending February 28th, 1920, in the sum of $1,348.71, and that of the amount so assessed the sum of $529.89 was erroneously and illegally assessed.

X

Plaintiff states that on or about the 25th day of January, 1923, the Commissioner of Internal Revenue and the collector of internal revenue for the district of Minnesota did serve upon this plaintiff a written notice and demand notifying this plaintiff that there had been assessed an additional income and profits tax for the fiscal year ending February 8, 1920, amounting to $1,348.71, which additional tax included said sum of $529.89, erroneously and illegally assessed, and demanded of this plaintiff the payment of the same.

4

XI

That on or about the 31st day of January, 1923, in order to prevent penalties and interest, and pursuant to the aforesaid demand, said plaintiff paid to said L. M. Willcuts, collector of internal revenue, the sum of $1,348.71, which included the sum of $529.89, erroneously and illegally assessed. Copy of receipt of said collector for said payment is hereto attached marked Exhibit "C" and made a part hereof. Said payment was duly made under protest and duress.

XII

That the commissioner, in arriving at the amount of the tax for the fiscal year ending February 28th, 1920, omitted from the computation of invested capital the undivided profits of the two preceding years, which profits remained in the business, amounting to $29,853.03, and such omission resulted in an illegal assessment of taxes amounting to $529.89.

XIII

Plaintiff states that prior to the making of said assessment of additional tax the books and accounts of this plaintiff were examined by an agent of the Commissioner of Internal Revenue, and that it appears from said examination that prior to the beginning of said fiscal year the capital of said corporation had been impaired by an operating deficit, and it further appeared from said examination that the profits remaining in said business for the two preceding fiscal years, and which remained in the business at the beginning of said fiscal year beginning February 28th, 1920, amounted to $29,-

853.03, and it further appears from the report of said agent that in computing said tax said agent and said Commissioner of Internal Revenue did exclude from the computation of invested capital said sum of $29,853.03, and said failure to include said sum in the computation of invested capital of this plaintiff was erroneous and illegal, and by reason thereof the additional assessment made against this plaintiff as aforesaid was erroneous and illegal in the amount of $529.89.

XIV

Plaintiff states that thereafter on or about the 9th day of February, 1923, it duly filed with the collector of internal revenue for presentation to the Commissioner of Internal Revenue an application for refund in manner and form as provided by the law and the regulations then in force, applicable to said case, copy of
5–6 which is attached hereto marked Exhibit "D" and made a part hereof, and that said Commissioner of Internal Revenue on July 30th, 1924, wholly disallowed and rejected said claim for refund.

XV

That by reason of the facts hereinbefore stated and alleged there is due and owing to this plaintiff from the defendant herein the sum of $529.89, with interest thereon from January 31st, 1923.

Wherefore plaintiff asks that its claim against the defendant be determined in the amounts above set forth, and that judgment be entered against said defendant for the sum of $1,804.19, with interest thereon from the 31st day of January, 1923, and for its costs and disbursements herein.

IRA C. OEHLER,
Attorney for Plaintiff,
143 Endicott Bldg., St. Paul, Minnesota.

[*Duly sworn to by Albert S. Gowen; jurat omitted in printing.*]

Exhibit "A" to complaint

Treasury Department.
United States Internal Revenue.
Form 1107.

Taxpayer's Receipt for Income and Excess Profits Tax.

Office Collector Internal Revenue.
Form No. of return Dec. C-218-1922 list. Tax $4,141.57
Add'l 1919 income tax.

Notice to Taxpayer.

Before presenting payment to cashier enter on this form.

(*a*) Name.
(*b*) Address.
(*c*) Form number of return.
(*d*) Amount of tax paid.

Name Milton Dairy Co.,
177 So. Franklin St.,
St. Paul, Minn.

Received payment.
Received with remittance.
Collector of Internal Revenue.
District of Minnesota,
Jan. 31, 1923.
St. Paul main office.

Exhibit "B" to complaint

Treasury Department.
Internal Revenue Service.
Form 843—Jan., 1922.
Comptroller General U. S.
January 18, 1922.

Claim for

[ ]	Abatement of tax assessed.
[ ]	Credit against outstanding assessments.
[ ]	Refund of taxes illegally collected.
[ ]	Refund of amount paid for stamps used in error or excess.

Important
File with Collector of Internal Revenue where assessment was made. Not acceptable unless completely filled in.

Collector's notation
District
Account number
Date received
Stamp here
Collector of Internal Revenue

State of Minnesota, } ss.
County of Ramsey, }

Notice to Collector
Collector must indicate in block above the kind of claim, except in income tax cases.

Date received by Administrative Unit
Stamp here

Type or Print

Milton Dairy Company, ----------
(Name of taxpayer or purchaser of stamps)

(Residence—give street and number as well as city or town and State)

177 S. Franklin St., St. Paul, Minn. ----------
(Business address)

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

Period	Year
From: Fiscal year To: Ending Feb. 28	19.. 1919

1. Business in which engaged: Manufacture and sale of dairy products.
2. Character of assessment or tax: Income and profits tax.
   (State for or upon what the tax was assessed or the stamps affixed.)
3. Amount of assessment or stamps purchased $4,141.57
4. Reduction of tax liability requested (income and profits tax) ..... $.....
5. Amount to be abated ..... $.....
6. Amount to be refunded (or such greater amount as is legally refundable) $1,274.30
7. Dates of payment (see collector's receipts or indorsement of canceled checks). Jan. 31, 1923.
   (If statement covers income tax liability, items 8–11, inclusive, must be answered.)
8. District in which return (if any) was filed ..... Minnesota.
9. District in which unpaid assessment appears
10. Amount of overpayment claimed as credit ..... $.....
11. Unpaid assessment against which credit is asked; period from ..... to ..... $.....

Deponent verily believes that this application should be allowed for the following reasons:

That in arriving at the amount of the tax for the year ending February 2, 1919, there was omitted from the computation of invested capital, the undivided profits of the preceding fiscal year, which profit remained in the business, amounting to $11,469.26, and such omission resulted in an illegal assessment of tax amounting to $1,274.30.

That the Milton Dairy Company is advised that the regulations under which the respective amounts of undivided profits are excluded from the computation of invested capital of this taxpayer are not in accordance with the revenue law of 1917 and the revenue law of 1918, or either of said laws, and said regulations and each of them are, so far as they deny this taxpayer the right to include such undivided profits, illegal.

Exhibit "B" to complaint—Continued

It appears from the return of the agent that the impairment of capital is occasioned by an operating deficit which is true and no part of the capital of said corporation has been distributed to the stockholders in any manner.

(Attach additional sheets if necessary)

Sworn to and subscribed before me this 9th day of February, 1923.

(Information not now available)
(Title)

Signed:

MILTON DAIRY COMPANY,
By ---

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge.)

Exhibit "C" to complaint

9–10
Treasury Department.
United States Internal Revenue.
Form 1107.

Taxpayer's Receipt for Income and Excess Profits Tax.

Office Collector Internal Revenue.
Form No. of return Dec. C–219–1922 list. Tax $1,348.71
Add'l 1920 income tax

Notice to Taxpayer.

Before presenting payment to cashier enter on this form.
(a) Name.
(b) Address.
(c) Form number of return.
(d) Amount of tax paid.

Name Milton Dairy Co.,
177 So. Franklin St.,
St. Paul, Minn.

Received Payment.
Received with remittance.
Collector of Internal.
Revenue.
District of Minnesota.
Jan. 31, 1923.
St. Paul Main Office.

Exhibit "D" to complaint

Treasury Department
Internal Revenue Service
Form 843—Jan., 1922
Comptroller General U. S.
January 18, 1922

Claim for

- ☐ Abatement of tax assessed.
- ☐ Credit against outstanding assessments.
- ☐ Refund of taxes illegally collected.
- ☐ Refund of amount paid for stamps used in error or excess.

Collector's notation
District.
Account number.
Date received.
Stamp here
Collector of Internal Revenue

Important
File with Collector of Internal Revenue where assessment was made. Not acceptable unless completely filled in.

State of Minnesota } ss.
County of Ramsey }

Notice to Collector
Collector must indicate in block above the kind of claim, except in income tax cases.

Date received by Administrative Unit

Stamp here

Type or Print

Milton Dairy Company, ----------
(Name of taxpayer or purchaser of stamps)

(Residence—give street and number as well as city or town and State)

177 S. Franklin St., St. Paul, Minn. ----------
(Business address)

Exhibit "D" to complaint—Continued

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

Period	Year
From: Fiscal Year	19----
To: ending Feb. 28	1920

1. Business in which engaged: Manufacture and sale of dairy products.
2. Character of assessment or tax: Income and profits tax.
(State for or upon what the tax was assessed or the stamps affixed.)
3. Amount of assessment or stamps purchased $ 1,348.71
4. Reduction of tax liability requested (income and profits tax) $
5. Amount to be abated $ 529.89
6. Amount to be refunded (or such greater amount as is legally refundable)
7. Dates of payment (see collector's receipts or indorsements of canceled checks) Jan. 31, 1923
(If statement covers income tax liability, items 8–11, inclusive, must be answered.)
8. District in which return (if any) was filed Minnesota.
9. District in which unpaid assessment appears
10. Amount of overpayment claimed as credit $
11. Unpaid assessment against which credit is asked; period from to $

Deponent verily believes that this application should be allowed for the following reasons:

That in arriving at the amount of the tax for the year ending February 28, 1920, there was omitted from the computation to invested capital, the undivided profits of the two preceding fiscal years, which profit remained in the business, amounting of $29,853.03, and such omission resulted in an illegal assessment of tax amounting to $529.89.

That the Milton Dairy Company is advised that the regulations under which the respective amounts of undivided profits are excluded from the computation of invested capital of this taxpayer are not in accordance with the revenue law of 1917 and the revenue law of 1918, or either of said laws, and said regulations and each of them are, so far as they deny this taxpayer the right to include such undivided profits, illegal.

It appears from the return of the agent that the impairment of capital is occasioned by an operating deficit which is true and no part of the capital of said corporation has been distributed to the stockholders in any manner.

(Attach additional sheets if necessary)

Sworn to and subscribed before me this 9th day of February, 1923.

(Information not now available)
(Title)

Signed:

MILTON DAIRY COMPANY,

By ---

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge.)

11 [File endorsement omitted.]

In United States District Court

Answer

Filed May 13, 1925

The defendant L. M. Willcuts, collector of internal revenue for the district of Minnesota, answering the complaint herein denies each and every allegation thereof.

Wherefore, defendant asks that judgment be entered against the plaintiff and for his costs and disbursements herein.

LAFAYETTE FRENCH, Jr.,
United States Attorney for the District of Minnesota and Attorney for Defendant.

[*Duly sworn to by L. M. Willcuts; jurat omitted in printing.*]

[File endorsement omitted.]

In United States District Court

[Title omitted.]

Findings of fact and conclusions of law

This cause came on for hearing on the 22nd day of June, 1925,
12 the plaintiff appearing by its attorney Ira C. Oehler, and the defendant appearing by his attorneys Lafayette French, jr., United States attorney for the district of Minnesota, and T. Ellis Allison, special attorney, Bureau of Internal Revenue of the United States, and the said parties upon appearing by their respective attorneys as aforesaid, said cause was on stipulation by both parties tried to the court, and the court having heard and considered the evidence introduced and the arguments of counsel, and being fully advised now makes the following findings of fact and conclusion of law:

Findings of fact

That plaintiff is and was during all of the times material herein a corporation duly organized and existing under the laws of the State of Minnesota, having its principal place of business in the city of St. Paul in said State, and that defendant is and was during all of the times material herein the duly appointed, qualified, and acting collector of internal revenue of the United States for the district of Minnesota.

That upon an audit of plaintiff's income tax returns filed for the fiscal years ending February 28, 1919, and 1920, said audit being verified by plaintiff's books of account and records, the Commis-

sioner of Internal Revenue of the United States assessed on December 22, 1922, additional income and excess profits taxes against plaintiff for the said fiscal years in the sums of $4,141.57 and $1,348.71, respectively. That the said Commissioner of Internal Revenue and defendant herein did on January 25, 1923, serve on plaintiff written notice and demand of said assessment and for payment thereof. That on January 31, 1923, plaintiff paid defendant the amount thereof. That on February 16, 1923, plaintiff made and filed its application for refund of a portion of said additional taxes, to wit: $1,274.30 for the fiscal year ending February 28, 1919, and $529.89 for the fiscal year ending February 28, 1920, which said claim for refund of $1,274.30 was by the Commissioner of Internal Revenue rejected in full on November 8, 1923, and which said claim for refund of $529.89 was by said Commissioner of Internal Revenue on July 8, 1924, rejected in full.

That in plaintiff's returns for the fiscal years ending February 28, 1919, and 1920, its invested capital was increased for the fiscal year 1919 by the sum of $11,489.26, and for the fiscal year 1920 by the sum of $29,853.03, which amounts were claimed by the plaintiff to be undivided profits or earned surplus. That the said sum of $11,489.26 was the amount of plaintiff's net income for the fiscal year ending February 28, 1918. That $22,908.14 was the
13 amount of plaintiff's net income for the fiscal year ending February 28, 1919. That the sum of $29,853.03 was the amount of plaintiff's profits remaining in its business at the beginning of the fiscal year beginning February 28, 1920, and which had remained in said business for the two preceding fiscal years. That plaintiff's net income for the fiscal years 1918 and 1919 was not divided or distributed. That on February 28, 1917, plaintiff had an operating deficit, which depleted its capital, shown on its books of $70,296.12, and still had the same unprovided for during the fiscal years ending February 28, 1919 and 1920, when it claimed the said sums of $11,489.26 and $29,853.03 as undivided profits or earned surplus. That on February 28, 1917, plaintiff's invested capital was $145,817.04. That the Commissioner of Internal Revenue upon its audit of the returns of the taxpayer for the fiscal years 1919 and 1920 refused to accept the invested capital set up by plaintiff therein, but reduced the invested capital of the corporation as claimed by the plaintiff for the fiscal year 1919 by the sum of $11,489.26, and for the fiscal year 1920 as claimed by the plaintiff by the sum of $29,853.03. That said amounts were by the Commissioner of Internal Revenue applied against the operating deficit aforesaid.

Conclusions of law

(1) That the court has jurisdiction to the parties to the suit and of the subject matter thereof.

(2) That defendant is entitled to judgment against the plaintiff and for his costs and disbursements herein.

Wherefore, it is ordered that judgment be entered accordingly.

Dated July 30, 1925.

JOSEPH W. MOLYNEAUX,
Judge.

In United States District Court

Judgment

Filed July 31, 1925

Wherefore, in accordance with said order it is—

Considered, ordered, and adjudged that the plaintiff herein, Milton Dairy Company, take nothing by its said action and that said defendant, L. M. Willcuts, collector of internal revenue for the district of Minnesota, do have and recover of and from said plaintiff his costs herein to be taxed.

In United States District Court

Opinion

Filed July 31, 1925

The facts in this case may be stated as follows: In the com-
14 putation by the taxpayer of its income and excess profits tax for the fiscal year ended February 28, 1918, and the fiscal year ended February 28, 1920, it adopted an invested capital; that upon an audit of the return of the taxpayer the Government refused to accept the invested capital set up, but reduced the invested capital of the corporation for the fiscal year 1919, by the sum of $11,489.26, and for the fiscal year of 1920, by the sum of $29,853.03, which amounts were claimed by the taxpayer to be undivided profits or earned surplus; that on February 28, 1917, the company had an operating deficit shown on its books of approximately seventy thousand ($70,000.00) dollars, and when it claimed to have earned surplus it still had the same unprovided-for deficit which was greater than the total alleged earned surplus for the two years in question.

Reduction in invested capital operates to increase taxes. The increase was accordingly assessed and paid and the correctness of the assessment is now in dispute. The statute involved is revenue act of 1918 (40 Statutes at Large, pages 1058, 1092, and 1093):

"Sec. 326. (a) That as used in this title the term 'invested capital' for any year means (except as provided in subdivisions (b) and (c) of this section):

"(1) Actual cash bona fide paid in for stock or shares;

"(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifi-

cally issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: Provided, That the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

"(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

"(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: Provided, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

"(b) As used in this title the term 'invested capital' does not include borrowed capital.

"(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

"(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

"The average invested capital for the prewar period shall be determined by dividing the number of years within that period during

the whole of which the corporation was in existence into the sum of the average invested capital for such years."

Plaintiff's contention is that under the provision—

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during year,"

16 the net profits for the two fiscal years above referred to should be added to the invested capital reducing the tax in the sum claimed in the complaint, $1804.19.

It is clearly provided by the statute that earned surplus or undivided profits constitute invested capital, but in my view the corporation did not have true earned surplus or undivided profits during the years in question. My view of this case is that the plaintiff's contention can not be sustained and that it violates the spirit and letter of section 326, rev. act of 1918 (40 Statutes at Large, pages 1058, 1092, and 1093).

The statute defines what assets shall go to make up "invested capital," at the time of the organization of the company or the inception of business, and an examination of the statute will show that such assets are to be taken at their real value in establishing the "invested capital," and as the corporation proceeds to conduct its business from year to year it may increase its capital stock by adding thereto the net surplus or profits. The question involved is, Did the taxpayer have any earned surplus or undivided profits for the fiscal year ended February 28, 1919, and the fiscal year ended February 28, 1920, which it could add to its "invested capital"? The statute provided the method of ascertaining invested capital at the organization of the corporation, specifically naming the items to be included and the items permitted would reflect the net assets of the corporation. The "invested capital" established by the corporation at its inception is not in controversy in this case. The controversy arose over the right of the taxpayer to increase the amount of the "invested capital" by the amount of the alleged earned "undivided profits" while it had upon its books the deficit referred to. The Government's claim is not that the earned surplus or undivided profits do not constitute "invested capital" but that the corporation had no true "earned surplus" or "undivided profits" during the years in question. At the time the corporation claimed to have "undivided profits" it had on its books a debit item denominated "operating deficit" which was in excess of the "undivided profits" for the two years in question.

This was a charge against the assets and reduced the assets in the amount of the debit. In computing its "surplus" or "undivided profits" it failed to take into account such debit. I think the scheme of the statutes is to ascertain the true value of the assets at the

17 inception of the corporation and to maintain the true value of the assets throughout the duration of the corporation, as the basis of calculating the amount of invested capital on which the tax is to be computed.

The corporation had a fixed invested capital at its inception, which represented the uninflated value of its assets. Only true earned surplus and undivided profits can be included in the computation of "invested capital" and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the accurate amount.

Holmes on Federal Taxation, 1919 ed., 728.

In order to do this in the present case it will be necessary to apply the earnings for the fiscal year 1919, $11,489.26, and the fiscal year 1920, in the sum of $29,853.03, against the $70,000 deficit upon the books.

JOSEPH W. MOLYNEAUX,
U. S. District Judge.

[File endorsement omitted.]

In United States District Court

Petition for writ of error and order allowing same

Filed Sept. 11, 1925

To the honorable District Court of the United States, District of Minnesota, Third Division, and to the Judges of said Court:

The plaintiff in the above entitled action feeling itself aggrieved by the judgment of said court in said cause entered therein on the 31st day of July, 1925, comes now by its attorney and petitions said court for an order allowing said plaintiff to prosecute a writ of error to the United States Circuit Court of Appeals for the Eight' Circuit, according to the laws of the United States in that behalf made and provided; and also that an order be made fixing the amount of security which plaintiff shall give upon said writ of error, and that upon the giving of said security all further proceedings in this court be suspended and stayed until the determination of said writ of error.

And your petitioner prays that a transcript of all of the proceedings in said cause together with the assignment of errors filed therein be duly authenticated and that the same be sent to the said Circuit Court of Appeals.

IRA C. OEHLER,
Attorney for Plaintiff.

18 Upon the motion of Ira C. Oehler, attorney for the plaintiff in the above-entitled cause, and upon the filing of the foregoing petition and the filing of the assignment of errors, it is by the court hereby ordered that a writ of error be, and hereby is allowed to have reviewed in the United States Circuit Court of Appeals for the

Eighth Circuit the said judgment heretofore entered herein; and that the amount of bond on said writ of error be, and hereby is fixed at $500.00.

Dated this 10th day of September, 1925.

JOSEPH W. MOLYNEAUX,
Judge.

[File endorsement omitted.]

In United States District Court

Assignment of errors

Filed Sept. 11, 1925

Comes now the Milton Dairy Company, plaintiff above named, and files the following assignment of errors upon which said plaintiff will rely in the Circuit Court of Appeals for the Eighth Circuit, for relief from the judgment rendered in said cause.

I

The court erred as a matter of law in holding that plaintiff's invested capital on February 28th, 1919, was $145,817.04.

II

The court erred as a matter of law in holding that plaintiff's invested capital on February 28th, 1920, was $145,817.04.

III

The court erred in failing to find that the sum of $11,489.26. net income of the plaintiff for the fiscal year ending February 28th, 1918, and left in the business, is an addition to the invested capital of the plaintiff for the years ending February 28th, 1919, and February 28th, 1920.

IV

The court erred in failing to find that the sum of $22,908.14, net income of the plaintiff for the fiscal year ending February 28th, 1919, and left in the business, is an addition to the invested capital of plaintiff for the year ending February 28th, 1920.

V

The court erred in determining that the earnings of the plaintiff for the fiscal year ending February 28th, 1919, and for the fiscal year ending February 28th, 1920, should be applied against the operating deficit on the books of the company, instead of making those earnings part of the invested capital of the plaintiff.

VI

The court erred in finding that defendant is entitled to judgment against the plaintiff.

VII

The court erred in ordering judgment against the plaintiff.

Wherefore said plaintiff prays that the judgment of the District Court of the United States for the District of Minnesota, Third Division, in the above-entitled action, be reversed, and that said court be directed to enter judgment in favor of the plaintiff Milton Dairy Company or grant a new trial of said cause.

IRA C. OEHLER,
Attorney for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

[Bond on writ of error for $500.00, approved and filed Sept. 11, 1925, omitted in printing.]

21 In United States District Court

Bill of Exceptions

Filed Oct. 15, 1925

CAPTION

The above entitled matter came on for hearing on June 22nd, 1925, at ten o'clock a. m., before Honorable Joseph W. Molyneaux, judge of said court, at the Federal Building, in St. Paul, Minnesota.

22 There were present and appearing Ira C. Oehler, Esq., on behalf of the plaintiff, and Lafayette French, jr., represented by T. Ellis Allison, Esq., on behalf of the defendant.

Thereupon the following proceedings were had:

ARGUMENT BY COUNSEL

Mr. OEHLER. The plaintiff and defendant in this case herewith stipulate that the plaintiff is a Minnesota corporation.

That the defendant now is and at all times mentioned in the complaint was the duly qualified and acting collector of internal revenue for the district of Minnesota.

That the Commissioner of Internal Revenue assessed an additional income and excess profits tax against the plaintiff for the fiscal year ending February 28th, 1919, in the amount of $4,141.57; that the defendant demanded payment of that sum of the plaintiff; that on January 31st, 1923, plaintiff paid said tax under protest; that claim

for refund was duly made, and filed with and disallowed by the Commissioner of Internal Revenue.

That the Commissioner of Internal Revenue assessed an additional income and excess profits tax against the plaintiff for the fiscal year ending February 28th, 1920, in the amount of $1,348.71; that the defendant demanded payment of said sum of the plaintiff; that on January 31st, 1923, plaintiff paid said tax, under protest; that claim for refund was duly made and [filled] with the Commissioner of Internal Revenue, and disallowed by commissioner.

This claim for refund and disallowance is only a condition precedent to the bringing of this suit.

That prior to the making of the two assessments the books and accounts of the plaintiff were examined by C. O. Mershon, an agent of the Commissioner of Internal Revenue; that a copy of his report, dated October 13th, 1921, furnished to the plaintiff by the Commissioner of Internal Revenue, may be received in evidence to show what the books of the plaintiff would show in connection with its income and profits tax liability for the years ending February 28th, 1914, to February 28, 1921, and that either party may refer to the facts stated in that report to the same extent that we would if the books themselves were in court.

23 That the invested capital of the plaintiff on February 28th, 1918, was $145,817.04.

That the books of the plaintiff on February 28th, 1917, show an operating deficit of $70,296.12.

That the net income of the plaintiff for the fiscal year ending February 28th, 1918, amounted to $11,489.26.

That the net income of the plaintiff for the fiscal year ending February 28th, 1919, amounted to $22,908.14.

That there was no distribution to stockholders of plaintiff in either of the fiscal years ending February 28th, 1918, February 28th, 1919, and February 28th, 1920.

That in computing the taxes due from plaintiff for the years ending February 28th, 1919, and February 28th, 1920, the Commissioner of Internal Revenue, each year, based the invested capital exemption on an invested capital of $145,817.04.

Mr. OEHLER. We now offer in evidence, Your Honor, the report of the examining agent, Mr. C. C. Marshon, referred to in stipulation.

The COURT. It will be received.

(Document marked "Plaintiff's Exhibit A.")

DEFENSE

(Argument to the court on behalf of the defendant by Mr. Allison.)

Mr. ALLISON. May I have a motion in the record for judgment, which I suppose you will deny.

The COURT. Yes.

STIPULATION APPROVING BILL OF EXCEPTIONS

It is stipulated by the above entitled parties through their attorneys that the foregoing transcript of the evidence and proceedings in said cause is correct, and the same may be certified by the Honorable Joseph W. Molyneaux, before whom said cause was tried, as a bill of exceptions containing a complete record and containing
24 all of the testimony and proceedings in said cause; said certificate may be made in the usual form according to the practice of this court.

ORA C. OEHLER,
Attorney for Plaintiff.
L. W. SCOTT,
Attorney for Defendant.

Dated this 9 day of October, 1925.

ORDER APPROVING BILL OF EXCEPTIONS AND AS TO ORIGINAL EXHIBIT

This cause having been brought on regularly before the court on this 9th day of October, A. D. 1925, upon the application of the plaintiff for the settling and certifying its proposed bill of exceptions, stipulated by defendant's attorney to be correct, and it having been stipulated that the same may be settled as the bill of exceptions in said cause;

It is ordered that the attached and foregoing be, and the same is hereby, settled as a true bill of exceptions in said cause, and I, the undersigned judge of the District Court of the United States, do hereby certify that the same contains all of the evidence received upon the trial of this action, the rulings of the court admitting or excluding the evidence and exceptions taken to said rulings, and all other proceedings in this action not otherwise of record herein.

It is further hereby certified that said bill of exceptions refers to the exhibit used in said cause, said exhibit being plaintiff's Exhibit "A," and that said exhibit was duly introduced in evidence upon the trial of said cause and marked as exhibit therein, and said original exhibit is not made a part of this bill of exceptions, it being stipulated by the parties hereto that same be not included, and it being deemed unnecessary by the undersigned judge of said court that said original exhibit be sent to the Circuit Court of Appeals.

JOSEPH W. MOLYNEAUX,
Judge, United States District Court.

Dated this 9th day of October, 1925.

[File endorsement omitted.]

25 In United States District Court

Præcipe for transcript of record

Filed Oct. 24, 1925

To the Clerk of said Court:

You will please prepare and forward to the clerk of the United States Circuit Court of Appeals for the Eighth Circuit at St. Louis, Missouri, as and for a transcript upon writ of error in the above entitled cause, copies of the following papers and records of said court in said cause:

1. Complaint.
2. Answer.
3. Bill of exceptions as settled by the judge of said court.
4. The judgment entered herein.
5. Petition and order for writ of error and fixing bond.
6. Writ of error.
7. Assignment of errors.
8. Bond and approval thereof.
9. Citation and admission of service.
10. This præcipe for record on writ of error.
11. Election as to printing of transcript of record.
12. Clerk's certificate.

Dated this 24th day of October, 1925.

HAYDEN S. COLE,
IRA C. OEHLER,
FREDERIC D. MCCARTHY,
Hayden S. Cole, Ira C. Oehler, and Frederic D. McCarthy,
Attorneys for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

In United States District Court

Election as to printing record

Filed Oct. 24, 1925

The undersigned, attorney for the plaintiff, Milton Dairy Company, in the above-entitled action, hereby files in the office of said clerk this notice of the election of said plaintiff to take and
26 file in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit, to be printed under the supervision of the clerk of said Circuit Court of Appeals under its rules, a transcript of the record on writ of error in said action.

IRA C. OEHLER,
Attorney for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

[Citation in usual form showing service on Lafayette French, jr., filed Sept. 14, 1925, omitted in printing.]

27 In United States District Court

[Title omitted.]

Writ of error and return

United States of America,—ss.
The President of the United States of America,
To the honorable the Judges of the District Court of the United States for the District of Minnesota, Third Division—Greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the said district court, before you, at the the June term, 1925, thereof, between Milton Dairy Company, a corporation, plaintiff, and L. M. Willcuts, collector of internal revenue for the district of Minnesota, defendant, manifest error hath happened, to the great damage of said plaintiff, as by its complaint appears,

We, being willing that error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then, under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the United States Circuit Court of Appeals for the Eighth Circuit, together with this writ, so that you have the said record and proceedings aforesaid at the city of St. Louis, Missouri, and filed in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit, on or before the 11th day of November,
28 1925, to the end that the record and proceedings aforesaid, being inspected, the United States Circuit Court of Appeals may cause further to be done therein to correct that error, what of right and according to the laws and customs of the United States should be done.

Witness, the Honorable William H. Taft, Chief Justice of the United States, this 11th day of September, A. D. 1925.

Issued at office in St. Paul, Minnesota, with the seal of District Court of the United States for the District of Minnesota, Third Division.

Seal
U. S. Dist. Court
Dist. of Minn.
Third Division

JOEL M. DICKEY,
Clerk of the District Court of the United States for the District of Minnesota.
By MARGARET L. MULLANE,
Chief Deputy.

Allowed this 10 day of September, A. D. 1925.

JOSEPH W. MOLYNEAUX,
United States Judge.

United States of America,
District of Minnesota,
Third Division—ss.

In obedience to the command of the above writ I herewith transmit to the Untied States Circuit Court of Appeals for the Eighth Circuit a duly certified transcript of the record and proceedings in the within entitled cause, with all things concerning the same.

In witness whereof I hereunto subscribe my name and affix the seal of the District Court of the United States for the District of Minnesota, Third Division.

Seal
U. S. Dist. Court
Dist. of Minn.
Third Division

JOEL M. DICKEY,
Clerk of the District Court of the United States for the District of Minnesota.
By MARGARET L. MULLANE,
Chief Deputy.

29 [Clerk's certificate to foregoing transcript omitted in printing.]

30 [Appearances of counsel omitted in printing.]

31 [Minute entry of argument and submission May 11, 1926, omitted in printing.]

32 In United States Circuit Court of Appeals, Eighth Circuit

No. 7235, September term, A. D. 1926

MILTON DAIRY COMPANY, PLAINTIFF IN ERROR vs. L. M. WILLCUTS, COLLECTOR OF INTERNAL revenue for the district of Minnesota, defendant in error	In error to the District Court of the United United States for the District of Minnesota

Mr. Ira C. Oehler (Mr. Haydn S. Cole and Mr. Frederic D. McCarthy were with him on the brief), for plaintiff in error.

Mr. John R. Wheeler, special attorney, Internal Revenue Bureau (Mr. Lafayette French, jr., U. S. attorney, Mr. L. W. Scott, assistant U. S. attorney, and Mr. A. W. Gregg, general counsel, Bureau of Internal Revenue, were with him on the brief), for defendant in error.

Opinion

Filed Sept. 25, 1926

Before SANBORN, Circuit Judge, and WOODROUGH and SCOTT, District Judges.

SANBORN, Circuit Judge, delivered the opinion of the court.

The plaintiff, the Milton Dairy Company, was liable to pay and paid income and excess profits taxes for the fiscal year ending February 28, 1919, and also for the fiscal year ending February 28, 1920, which it claimed were excessive to the amount of $1,804.19, and it seeks by this action to recover this amount from the defendant, the collector.

33 Pursuant to the established methods of ascertaining the amount of its income and excess profits taxes it made a return and statement of the income for each of these two years and deducted therefrom the "invested capital" of section 326 (a) of the revenue act of 1918, 40 Statutes at Large, p. 1058, 1092, 1093. The Congress by that act specified the items that might lawfully be thus deducted and declared them to be parts of the "invested capital" of that act. Therefore the increase of this "invested capital" necessarily decreased the taxable income and the tax and the decrease of this "invested capital" increased the taxable income and tax of the plaintiff for each of these years.

Section 326 (a), so far as relevant to the question in this case, provided:

"That as used in this title the term 'invested capital' for any year means * * *

"(1) Actual cash bona fide paid in for stock or shares.

"(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares * * *.

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year."

The plaintiff had a net income of $11,489.26 in the fiscal year ending February 28, 1918, which remained undivided and undistributed in use in its business during the years 1919 and 1920, and a net income of $22,908.14 in the fiscal year ending February 28, 1919, which remained undivided and undistributed in use in its business during the year 1920. In making its return and statement of its income and profits for the fiscal year 1919 it stated and claimed this $11,489.26 undivided profits as part of its "invested capital" of that year, and in making its return and statement of its income and profits of the year 1920 it stated and claimed this $22,908.14 undivided profits as part of its "invested capital" of that year. The Commissioner of Internal Revenue disallowed these claims and these disallowances resulted necessarily in an increase of the plaintiff's income and excess profits taxes for the fiscal years 1919 and 1920 by $1,804.19, which it paid under protest and brought this action to recover.

34 The only justification for these disallowances is the fact that in the fiscal year 1917 the plaintiff sustained a disastrous operating deficit in the conduct of its business which depleted its prior capital $70,296.12 and this declaration in Regulations 45, article 838: "There can, of course, be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good;" and the fact that Holmes on Federal Taxation, page 728 of the 1919 edition and page 1057 of the 1922 edition, prints the substance of this article 838 in the words thereof.

On the other hand, however, art. 860 of Regulations 45 revised declares that: "Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital."

The argument in support of the commissioner's ruling and his decision in this case is that the allowance and the deduction of undivided profits of any fiscal year is conditioned by an excess of the value of the assets of the taxpayer over its liabilities at the end of that fiscal year and the practical effect of the imposition of such a condition is to exclude and except from the benefit of the deduction of "undivided profits" as part of the "invested capital" of section 326 (a) in the process of computing their taxable income and excess profits, all taxpayers of income and excess profits the value of whose assets through operating deficits or unfortunate losses in prior years have become less than their liabilities at the end of any subsequent fiscal year.

But the Congress by declaring undivided profits parts of invested capital by section 326 (a) seems to have granted this deduction to all payers of taxes on income and excess profits without excepting those whose assets did not exceed their liabilities and without the condition imposed by the ruling of the commissioner. There is certainly no expressed exception in the statute of taxpayers whose assets are less than their liabilities from the benefits of the grant and no expressed condition that the assets of the beneficiaries must equal or exceed their liabilities. As the Congress did not expressly make
35 any such exception or impose any such condition the legal presumption is that it did not intend so to do. There are other considerations persuasive of that conclusion.

By section 326 (a) (3) paid-in or earned surplus and undivided profits are made a part of the invested capital of that section and the invested capital of that section is not the same, has not the same meaning, and is not equivalent to the common, ordinary invested capital of commerce, but is unique and arbitrary and means only the items there specified as a part of that invested capital.

"The word surplus," says Mr. Justice Brandeis in Edwards v. Douglas, 46 Supreme Court Reporter 88, "is a term commonly employed in corporate finance and accounting to designate an account on corporate books. But this is not true of the words undivided profits. The surplus account represents the net assets of a corporation in excess of all liabilities, including its capital stock. This surplus may be paid in surplus, as where the stock is issued at a price above par; it may be earned surplus as where it was derived wholly from undistributed profits; or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property * * *. By most corporations the term undivided profits is employed to describe profits which have neither been distributed as dividends nor carried to surplus account upon the closing of the books; that is, current undistributed earnings"; and that was the meaning upon which the decision in that case was based. And it seems certain that surplus in the sense of the excess of the value of assets over liabilities is not the same as the surplus or the undivided profits of section 326 (a) and does not necessarily condition the existence of either of them and that a taxpayer may have at the close of a fiscal year the undivided profits of section 326 (a), although it has no surplus of assets over liabilities and no earned surplus. In other words, it may have undivided profits of a fiscal year insufficient to constitute earned surplus, and it evidently was to grant the just deduction on account of such undivided profits that the Congress provided that earned surplus and undivided profits, not earned surplus or undivided profits, should constitute parts of the invested capital of that section.

It is well settled that the dominant purpose and practice of Congress in imposing taxes on income and excess profits was to
36 place the peculiar burden of these taxes on a graduated scale so that the heavier portion of the burden thereof should fall on those best able to bear them. The exception introduced by the commissioner of those payers of income taxes on excess profits who have been so unfortunate as to have suffered in earlier years depletion of their original business capital and have been unable to restore it, from the benefit of the deductions granted to them by Congress by section 326 (a) runs counter to that purpose and practice and tends to place the heavier burden of these taxes on those less able to bear them. If the Milton Dairy Company had not sustained its unfortunate operating deficit of 1917 and thereby the depletion of its business capital it would have enjoyed the benefit of the deductions granted to it by section 326 (a) (3) on account of its undivided profits of the fiscal years ending February 28, 1919, and February 28, 1920, and would not have been compelled or asked to pay the $1,804.19 here in controversy. Nor is this the worst of it. If this exception continues in force and in operation and the plaintiff remains unable to restore its original business capital it must continue to lose the benefit of this grant of deductions on account of its future undivided profits and to pay these excessive taxes on account of its

misfortune, and other payers of income taxes and excess profits in like situation whose capital has been depleted by unfortunate losses in earlier years and has not been restored must submit to like penalties for those misfortunes. We find no warrant for such an exception in the acts of Congress, nor are we persuaded that the Members of Congress ever intended to authorize or permit such an exception or practice.

Taxes on income and excess profits are annual taxes. The required return, statement, computation, and amount for each year are separate and distinct from those of every other year. The undivided profits of section 326 (a) (3) are the undivided profits of the single fiscal year for which the return is made, excepting the surplus and undivided profits earned during that year. The Congress provided that such undivided profits of each fiscal year should constitute parts of the invested capital of that section, and thereby granted proportionate reductions of the income of the taxpayer in the process of ascertaining its taxable income and excess profits, and in our opinion it was not and is not within the lawful jurisdiction or power of the
37 administrative officers or of the courts of the United States to make such an exception from or impose such a condition upon that grant. Lynch *v.* Alworth-Stephens Co., 267 U. S. 364. Let the judgment below be reversed and let the case be remanded to the court below with instructions to grant a new trial.

38 In United States Circuit Court of Appeals, Eighth Circuit

[Title omitted.]

Judgment

September 25, 1926

This cause came on to be heard on the transcript of the record from the District Court of the United States for the District of Minnesota and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the judgment of the said District Court, in this cause, be, and the same is hereby, reversed with costs; and that the Milton Dairy Company have and recover against L. M. Willcuts, collector of internal revenue for the district of Minnesota, the sum of one hundred nineteen and 45/100 dollars for its costs in this behalf expended and have execution therefor.

It is further ordered by this court that this cause be, and the same is hereby, remanded to the said District Court with instructions to grant a new trial.

39 In United States Circuit Court of Appeals, Eighth Circuit

Clerk's certificate

I, E. E. Koch, clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing contains

the transcript of the record from the District Court of the United States for the District of Minnesota as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, and full, true, and complete copies of all the pleadings, record entries, and proceedings, including the opinion, had and filed in the United States Circuit Court of Appeals, except the full captions, titles, and endorsements omitted in pursuance of the rules of the Supreme Court of the United States, in a certain cause in said Circuit Court of Appeals wherein Milton Dairy Company was plaintiff in error and L. M. Willcuts, collector of internal revenue for the district of Minnesota, was defendant in error. No. 7235, as full, true, and complete as the originals of the same remain on file and of record in my office.

I do further certify that on the twenty-sixth day of November, A. D. 1926, a mandate was issued out of said Circuit Court of Appeals in said cause, directed to the judges of the District Court of the United States for the District of Minnesota.

In testimony whereof I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the city of St. Louis, Missouri, this second day of December, A. D. 1926.

[SEAL.]

E. E. KOCH,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

40 In Supreme Court of the United States

Order allowing certiorari

Filed January 24, 1927

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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